In the Supreme Court of the United States

OCTOBER TERM, 1973

No.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

IDAHO POWER COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Ninth Circuit.

OPINIONS BELOW

The memorandum findings of fact and opinion of the Tax Court (Appendix A, *infra*, pp. 10–19) are not officially reported. The opinion of the court of appeals (Appendix B, *infra*, pp. 20–37) is reported at 477 F.2d 688.

JURISDICTION

The judgment of the court of appeals (Appendix C, *infra*, p. 38) was entered on April 10, 1973. By order dated July 5, 1973, Mr. Justice Douglas extended the time for filing a petition for a writ of certiorari to and including August 8, 1973. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

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QUESTION PRESENTED

Whether the depreciation on equipment owned and used by the taxpayer in the construction or improvement of its capital facilities must be capitalized as part of the cost of those facilities.

STATUTES INVOLVED

Sections 161, 167, and 263 of the Internal Revenue Code of 1954, 26 U.S.C. 161, 167, and 263, provide in pertinent part as follows:

> Section 161. In computing taxable income * * *, there shall be allowed as deductions the items specified in this part [Sections 161 through 188], subject to the exceptions provided in Part IX (sec. 261 and following, relating to items not deductible).
>
> Section 167(a). There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear * * * of property used in the trade or business * * *.
>
> Section 263(a). No deduction shall be allowed for—
>
> (1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. * * *

STATEMENT

Respondent is a public utility company engaged in the production, transmission, distribution and sale of electric energy.[1] In connection with its principal business, respondent also constructs additions and improvements to its capital facilities. Some of this con-

[1] The facts recited herein are taken from the Tax Court's memorandum findings of fact (Appendix A, *infra*, pp. 10–13).

struction is done by independent contractors, but much of it is done directly by respondent, using its own employees and equipment. The major construction work consists of additions to or improvements in transmission lines, transmission switching stations, distribution lines, distribution stations, and connecting facilities.

In performing its own construction work, respondent uses a wide variety of automotive transportation equipment, including passenger cars, trucks of all description, power operated equipment and trailers, and so forth. For its general accounting purposes, including reporting to regulatory agencies responsible for rate-making and other related determinations, respondent treated the depreciation on this equipment, to the extent it was used in construction, as part of the cost of the capital facilities so constructed. Thus for accounting purposes the depreciation was capitalized and then amortized over the life of the capital facilities.[2] For tax purposes, however, respondent treated the depreciation not as a capital expenditure but as a currently deductible item of expense.

The Commissioner determined that the construction-related depreciation on respondent's equipment was a nondeductible capital expenditure under Sec-

[2] Respondent also capitalized substantially all the costs of operating and maintaining the construction equipment, including the wages paid to operators, the cost of fuel, and so forth, as well as the cost of tools and other materials wholly consumed in the course of construction. Respondent does not contest the propriety of treating these items as nondeductible capital expenditures for tax purposes.

tion 263 of the Internal Revenue Code of 1954, 26 U.S.C. 263. He therefore adjusted respondent's federal income tax returns for the taxable years in question, 1962 and 1963, by disallowing the construction-related depreciation on equipment, adding the amount of the disallowed depreciation to respondent's adjusted basis in its capital facilities, and accordingly increasing the depreciation allowed with respect to those facilities. The net effect of these adjustments was to increase respondent's tax liability for 1962 by $140,429.75 and for 1963 by $96,811.95.

The Tax Court sustained the Commissioner's determination (Appendix A, *infra*). The court of appeals reversed (Appendix B, *infra*), apparently reasoning alternatively that construction-related depreciation is not a capital expenditure under Section 263 of the Code and that Section 263 does not in any event bar the deduction of capital expenditures which would otherwise be deductible as depreciation under Section 167.

REASONS FOR GRANTING THE WRIT

1. The court of appeals has decided a question of major significance to the administration of the Internal Revenue Code in a manner which conflicts with the result in the only other reported case expressly addressing that issue, *Southern Natural Gas Co. v. United States*, 412 F. 2d 1222, 1264–1269 (Ct. Cl.). Unless reversed, the decision below will have a substantial adverse effect on the revenues. The Internal Revenue Service estimates that acceptance of the decision below could result, in the first year, in a revenue loss from the electric utility industry alone of approxi-

mately forty million dollars.[3] Railroads, other utilities, and major industrial corporations are also affected. Heretofore, such taxpayers, in filing their returns, have generally followed a method of depreciation accounting similar to that urged by the Commissioner in this case. If the issue now raised is not quickly resolved by this Court, further litigation involving, in the aggregate, hundreds of millions of dollars in refund claims may be anticipated.

2. Good accounting practice requires the capitalization of all costs incurred in the acquisition of capital assets. When a taxpayer acquires a capital asset by constructing it, this principle requires capitalization of the construction costs themselves. The application of this principle is of course clear with respect to expenditures such as wage payments to construction workers and purchase costs of construction materials. But it also applies to the cost of operating construction equipment, including the wear and tear, or depreciation, of the equipment itself. See, *e.g.*, Paton, *Asset Accounting: An Intermediate Course,* pp. 192–193 (1st ed.); Finney & Miller, *Principles of Accounting—Introductory,* pp. 246–247 (6th ed.).[4]

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[3] Revenue losses in subsequent years could be expected to decline. The issue presented here, as in, for example, *Schlude* v. *Commissioner*, 372 U.S. 128, and *American Automobile Assn.* v. *United States*, 367 U.S. 687, involves the deferral of taxes. But in a growing economy, the annual revenue losses resulting from such a deferral would continue indefinitely.

[4] The court of appeals inferred from the 1954 liberalization of tax depreciation rules under Section 167 a congressional purpose of favoring immediate deductions over capitalization. But those liberalized rules, the application of which is not at issue here, were intended to "give the economy added stimulus and resilience *without departing from realistic standards of depreciation accounting.*" H. Rep. No. 1337, 83d Cong., 2d Sess., p. 24 (1954). (Emphasis added.)

Construction-related depreciation is simply one more item of cost incurred in acquiring a capital asset. As such, good accounting practice requires that it be capitalized and amortized over the useful life of that capital asset, *i.e.* over the period that asset is used in the production of income.[5] This treatment of construction-related depreciation follows from the fundamental accounting principle that expenditures are to be deducted as expenses only in the period or periods during which they are associated with the production of income: construction-related depreciation is associated with the production of income not when it is originally incurred, but over the life of the asset constructed.

Elementary principles of income taxation are in agreement with good accounting practice on this issue. The general principle that a taxpayer's construction costs must be capitalized and amortized over the life of its newly constructed facility has long been established. See, *e.g., Great Northern Railway Co.* v. *Commissioner,* 8 B.T.A. 225, 260–263, affirmed, 40 F. 2d 372 (C.A. 8), certiorari denied, 282 U.S. 855. Respondent concedes this point with respect to the normal expenses of operating and maintaining its construction equipment. See note 2, *supra.* Respondent balks only at the capitalization of depreciation.

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[5] In recognition of the dictates of good accounting practice, both the Federal Power Commission and the Idaho Public Utilities Commission have required respondent to capitalize construction-related depreciation in its reports to them. See Appendix A, *infra,* p. 12; Appendix B, *infra,* p. 22.

But in adjudicating tax cases this Court has frequently pointed out that "the purpose of depreciation accounting is to allocate the expense of using an asset to the various periods which are benefited by that asset." *Hertz Corp.* v. *United States*, 364 U.S. 122, 126. The periods benefited by a taxpayer's use of equipment to construct its own capital facilities are those during which the facilities so constructed are themselves used for the production of income. Thus immediate deduction of construction-related depreciation would be inappropriate. The proper matching of items of income and expense can be achieved only by treating construction-related depreciation in the same manner as other construction expenditures, *i.e.*, as nondeductible capital expenditures that must be added to the adjusted basis of the new facility.[6]

3. This result is also required by the clear language of the Internal Revenue Code. The deduction for depreciation is provided by Section 167. Respondent claims that its construction equipment was used in its trade or business and therefore is subject to the provisions of that Section. We concede that Section 167, read alone, literally applies to respondent's construction equipment. But Section 167 cannot be read alone: Section 161 makes all business-related deductions, including the deduction for depreciation under Section

[6] This treatment maintains a tax parity between the taxpayer that constructs its own facilities and one that hires an independent contractor. The latter taxpayer must of course capitalize the entire amount of the construction costs charged by the contractor, and in any normal arm's-length agreement this amount will cover the depreciation incurred by the contractor in using his equipment.

167, "subject to the exceptions provided in [Sections 261 through 279]." And Section 263 broadly disallows any deduction for "[a]ny amount paid out for new buildings or for permanent improvements or betterments * * *."[7] The Treasury Regulations, 26 C.F.R. 1.263(a)-2(a), confirm that the disallowance under Section 263 extends to the "*cost of* acquisition, *construction, or erection* of buildings * * * and similar property * * *." (Emphasis added.)

Apparently the principal ground of decision below was that, although Section 263 may require the capitalization of other costs of construction, it does not extend to construction-related depreciation because such depreciation is not an "amount paid." But that statutory expression does not refer only to actual payments. For example, respondent properly has never claimed that it could deduct, rather than capitalize, the construction workers' wages or construction materials' purchase costs accrued but not actually paid during a taxable year, even though such accruals are not "amount[s] paid" under the reading of the court below. This illustrates that the statutory phrase "amount paid out" was not intended to invoke

[7] The court of appeals expressed the view that Section 263 disallows only those expenses which would otherwise be deductible only as ordinary and necessary business expenses under Section 162. But the broad language of Section 263 ("No deduction shall be allowed * * *") and of Section 161 ("* * * the items specified in this part [are] subject to the exceptions provided in part IX * * *") does not admit of such a narrow construction. Cf. *United States* v. *Mississippi Chemical Corp.*, 405 U.S. 298 (involving capitalization of expenditures which the taxpayer sought to deduct as interest payments under Section 163).

the principles of cash-basis accounting, as the court of appeals mistakenly concluded, but instead was used synonymously with "cost incurred."[8] Respondent's construction-related depreciation is a cost incurred in the acquisition of new capital facilities, and as such it is a nondeductible capital item under the statute.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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[8] Moreover, the narrow, technical reading of the statute by the court of appeals exhibits a basic misunderstanding of the purpose of Section 263. That purpose is to state the broad principle that capital expenditures are nondeductible; it was not intended as "a complete list of nondeductible expenditures." *Commissioner* v. *Lincoln Savings and Loan Ass'n*, 403 U.S. 345, 358. Thus Section 263 is to be read expansively, in the same manner as Section 61. Cf. *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426.

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APPENDIX A

[1] [Filed, April 13, 1970]

United States Tax Court

T.C. Memo 1970-83

Docket No. 4012-67

IDAHO POWER COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Memorandum Findings of Fact and Opinion

SCOTT, *Judge*: Respondent determined deficiencies in petitioner's Federal income taxes for the calendar years 1962 and 1963 in the amounts of $73,023.47 and $50,342.21, respectively.

The only issue in this case is whether petitioner is entitled to deduct the portion of the depreciation on transportation equipment used [2] both for maintaining existing and building new facilities attributable to construction of the capital improvements.

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly.

Petitioner, a public utility engaged in the production, transmission, distribution and sale of electric energy, was incorporated under the laws of Maine on May 6, 1915. Its principal place of business at the time of filing its petition in this case was in Boise,

Idaho. It filed its Federal income tax returns for the calendar years 1962 and 1963 with the district director of internal revenue at Boise, Idaho.

Petitioner kept its books and filed its Federal income tax returns on an accrual method of accounting.

Ever since it was organized, petitioner has engaged in some construction of additions to its property. During the latter part of World War II because of the unavailability of outside contractors, petitioner constructed all the new additions to its transmission and distribution facilities. At all other times some of its capital improvements have been constructed by contractors and some by petitioner with its own employees. At the time of the trial of this case petitioner had 140 employees engaged in new construction work. In prior years petitioner had as many as 300 employees engaged in constructing capital improvements.

[3] The approximate gross amounts of property constructed by petitioner and by others as added each year to petitioner's property-account for the years 1961 through 1963 are as follows:

Year	Gross Additions	Amount Constructed by Petitioner	Amount Constructed by Others Under Contract	Purchased Equipment
1961	$65,407,029.28	$14,609,896.38	$41,262,380.48	$9,534,752.42
1962	[1] 8,235,440.22	7,139,940.72	314,790.45	780,709.05
1973	5,988,139.56	5,642,342.79	115,792.63	230,004.14

[1] The stipulation shows this figure as $8,235,640.22. The record does not show whether the error is in the total or one of the other figures. For simplicity we have corrected the total from $8,235,640.22 to $8,235,440.22.

These additions were primarily transmission lines, transmission switching stations, distribution lines, distribution stations and connecting facilities such as roads and timber turnings.

During each of the years 1962 and 1963 petitioner owned automotive transportation equipment used in its business. Communication equipment, such as radios, was affixed to the transportation equipment and used in the operation of such transportation equipment. Petitioner used such transportation equipment in part for operation and maintenance and in part for the construction of additional facilities having a useful life of more than one year.

The types of automotive transportation equipment owned by petitioner during the years 1962 and 1963 included passenger cars, pickup trucks, light trucks, medium trucks, heavy trucks, power operated equipment and [4] trailers. All of this equipment is used for operation, maintenance and construction. Petitioner on its books uses various methods of charging the operating expenses of this equipment to operation and maintenance and construction, none of which is questioned by respondent. To the extent used in construction, petitioner on its books charged depreciation on its transportation equipment as well as all costs of operating and maintaining such transportation equipment, except pension contributions, social security taxes and motor vehicle taxes to the capital assets so constructed. Depreciation was charged either directly or through clearing accounts in accordance with accounting procedures prescribed by the Federal Power Commission which have been adopted by the Idaho Public Utilities Commission. The depreciation so capitalized on petitioner's books of account for the years 1962 and 1963 amounted to $150,047.42 and $130,523.99, respectively.

In computing its taxable income as reported on its Federal income tax returns for 1962 and 1963, petitioner capitalized as a part of the cost of construction of its capital improvements all costs of operating and

maintaining its transportation equipment which it had charged on its books to construction.

On its Federal income tax returns for the years here in issue petitioner deducted all depreciation on all its transportation equipment including depreciation allocated on its books to use of the equipment in construction. Such equipment was depreciated over a composite life of 10 years. Petitioner depreciated all of its automotive transportation [5] equipment whether or not used in construction under the straight line and declining balance methods of depreciation.

Respondent in his notice of deficiency disallowed and capitalized the deduction for depreciation on taxpayer's transportation equipment to the extent that such equipment was used in the construction of capital assets and allowed a deduction for depreciation on the amounts so capitalized over the useful life of the property constructed. The result of this adjustment was the disallowance by respondent of depreciation claimed by petitioner in the years 1962 and 1963 in the respective amounts of $140,429.75 and $96,811.95.

OPINION

Petitioner takes the position that its transportation equipment is used in its trade or business and therefore depreciation on this equipment is deductible under section 167(a)(1), I.R.C. 1954.[2] Respondent

[2] All references are to the Internal Revenue Code of 1954.

SEC. 167, I.R.C. 1954. DEPRECIATION.

"(a) General Rule.—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

"(1) of property used in the trade or business, or

"(2) of property held for the production of income."

contends that the amount of such depreciation allocable [6] to use of petitioner's equipment in the construction of capital improvements should be capitalized in accordance with the provisions of section 263(a)(1).[3]

Petitioner states that its construction of its own facilities is an appropriate activity in connection with its production and sale of electric energy and cites numerous cases for the proposition that the phrase "property used in the trade or business" means devoted to such trade or business, regardless of whether or not such property was used in activities directly productive of income. All of the cases which petitioner cites in support of this contention deal with temporarily idle assets. Typical of the holdings of the cases cited by petitioner is our statement in *Carter-Colton Cigar Co.* 9 T. C. 219, 221 (1947) that:

> Where the statute allows deductions for depreciation of property "used in the trade or business," it has been held that "used in the trade or business" means "devoted to the trade or business," and includes all such property, whether actually in use during the taxable year or not. * * *

These cases are not helpful in resolving the issue in the instant case. All the transportation equipment for which petitioner claimed depreciation was used part of the time in its trade or business of production and sale of electric energy and the portion of the [7] depreciation allocated to this "business" on petition-

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[3] SEC. 263(a) CAPITAL EXPENDITURES.

"(a) General Rule.—No deduction shall be allowed for—

"(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. * * *"

er's books has not been disallowed by respondent. This same equipment was used part of the time to construct capital improvements and respondent contends that the amount of depreciation allocable to such use should be capitalized and in effect considered as a part of the cost of the facility constructed. Respondent contends that petitioner was not "in the trade or business" of constructing facilities and that even if this activity is considered a part of petitioner's trade or business the deduction of any capital expenditure in connection therewith is prohibited by the provisions of section 263.

Petitioner argues that there is ample authority in support of the proposition that a taxpayer's trade or business includes all activities which are appropriate to its principal business, citing cases in which various activities such as purchase of corn futures, sale of baseball player contracts, and trading in currency[4] were determined to be appropriate to the taxpayer's principal business and therefore give rise to ordinary income. These cases are likewise not helpful in resolving the issue in the instant case. Obviously the acquiring of capital improvements whether by purchase or construction is appropriate [8] if not vital to petitioner's continued operation of its business of producing and selling electric energy but this fact does not cause the cost of these capital improvements to be deductible in the year acquired. The real issue here is whether the portion of the depreciation deduction for transportation equipment allocable to the construction of capital improvements should be viewed

[4] *Corn Products Refining Co.* v. *Commissioner*, 350 U.S. 46 (1955); *Hollywood Baseball Association*, 49 T.C. 338 (1968), aff'd. 352 F. 2d 350 (C.A. 9, 1969); and *American Southeast Asia Company, Inc.* 26 T.C. 198 (1956).

as a part of the "cost" of such capital improvements.

Petitioner further argues that disallowing the portion of the claimed depreciation deduction allocable to transportation equipment used in constructing capital improvements ignores the basic reason for allowing depreciation, that is, to permit a taxpayer to recoup the cost of equipment free of tax over its useful life so that it will have funds to replace such equipment.

This argument begs the question. The reason for allowing a depreciation deduction is because the statute allows this method of recovering the cost of a piece of equipment with a useful life of over one year instead of allowing the total cost of such equipment used in a trade or business to be deducted in the year of purchase as a business expense. A deduction as a business expense is allowed for the type of tools, parts and equipment used in a trade or business which do not have a useful life of over one year such as the repair parts for petitioner's transportation equipment. However, petitioner has capitalized such items allocable to the construction of capital improvements.

[9] Finally, petitioner argues that section 263(a) could not apply to depreciation since depreciation is not "any amount paid out," relying on *Maurice S. Gordon* v. *Commissioner*, 37 T.C. 986, 987 (1962) and quoting our statement therein that "The statute [Sec. 213 allowing deduction for medical expenses] permits the deduction for 'expenses paid' and 'amounts paid' and respondent correctly interprets the statute as permitting deduction for 'medical expenses actually paid.' Sec. 1.213–1(a), Income Tax Regs. Depreciation is a 'decrease in value.' *Massey Motors, Inc.* v. *United States*, 364 U.S. 92, 96. Any allowance for depreciation is not an 'expense paid' or 'amount paid.'" As is

shown by the sentence preceding those quoted by petitioner and as we held in *Producers Chemical Co.*, 50 T.C. 940, 959 (1968) the case of *Maurice S. Gordon v. Commissioner, supra*, held that depreciation was not an expense paid "in the year for which the deduction was claimed" and that case has no relevance to the issue of whether depreciation is to be deducted or capitalized.

Section 263(a) provides that no deduction shall be allowed for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. Petitioner does not question that the cost of tools with a life of less than one year used to construct capital assets or permanent improvements should be capitalized. Depreciation of equipment used for the construction of a capital asset is of the same nature as the cost of tools [10] "paid out" for a capital improvement. As we stated in *L. W. Brooks, Jr.*, 50 T.C. 927, 935 (1968) on appeal (C.A. 5, Feb. 10, 1969) "* * * depreciation—inasmuch as it represents a using up of capital—is as much an 'expenditure' as the using up of labor or other items of direct cost."

In *Ben Perlmutter*, 44 T.C. 382, 404 (1965) aff'd on another issue 373 F. 2d 45 (C.A. 10, 1965), we held that an allocable portion of the depreciation on vehicles used in construction of a shopping center should be capitalized, pointing out that "petitioner has the burden of establishing that the disputed expenditures were actually incurred *in carrying on* the business of the corporation, * * * and this petitioner has failed to do."

Petitioner relies heavily on *Great Northern Railway Co.*, 30 B.T.A. 691 (1934) in which we held that the taxpayer was entitled to deduct depreciation on certain equipment used in construction work.

As we pointed out in *Producers Chemical Co., supra,* at page 960, in our view "all that was held in the second *Great Northern Railway Co.* case [30 B.T.A. 691] was that the depreciation which the taxpayer there sought to deduct was incurred in carrying on the trade or business of the taxpayer." We also pointed out the distinction between *Great Northern Railway Co.,* 8 B.T.A. 225, 263 (1927) which held it proper to capitalize depreciation on equipment used to transport men for construction work, and the second *Great Northern Railway Co.* [30 B.T.A. 691 (1934)] case in some detail.

[11] In our view the issue in the instant case is indistinguishable in substance from the issue involved in *L. W. Brooks, Jr., supra, Producers Chemical Co., supra,* and *Ben Perlmutter, supra,* in each of which we held that the portion of depreciation on equipment allocable to acquisition of a capital asset is not properly deductible in the year the equipment is used to produce such asset but must be capitalized and recovered as a part of the basis of the capital asset acquired over the useful life of such asset.

Southern Natural Gas Co. v. *United States,* 412 F. 2d 1222 (Ct. of Cl. 1969), a recent case decided by Court of Claims, involved the precise issue as that involved in the instant case. The taxpayer in that case was an interstate natural gas carrier which constructed additional facilities to expand its pipeline system. Certain equipment which it owned was used primarily for the operation and maintenance of the system but from time to time was used to construct additional facilities. The Court of Claims held that the depreciation allocable to the use of the equipment in the construction of capital improvements was not deductible in the year the equipment was so used but should be capitalized and recovered over the useful

life of the assets constructed. Petitioner recognizes that the *Southern Natural Gas Co.* case is not distinguishable from the instant case but contends that the Court of Claims in accepting the report of its Commissioner as its decision on this issue wrongly decided the issue. In our view the decision of the Court of Claims in the *Southern Natural Gas Co.* case with respect to the capitalization of [12] depreciation of equipment used in the construction of capital improvements is correct. It is in accordance with our holdings in *L. W. Brooks, Jr., supra, Producers Chemical Co., supra,* and *Ben Perlmutter, supra.* That decision is also supported by a number of cases decided by this Court such as *Great Northern Railway Co.,* 8 B.T.A. 225 and *New Quincy Mining Co.* 36 B.T.A. 376, 382 (1937).

There is no dispute between the parties as to the amount of depreciation allocable to construction of capital improvements. We hold that respondent properly disallowed as a deduction in the years here in issue this allocable portion of depreciation and that such amount should be capitalized as part of petitioner's basis in the permanent improvements in the construction of which the equipment was used.

Decision will be entered for respondent.

APPENDIX B

[1] United States Court of Appeals
for the Ninth Circuit

No. 26,368

[April 10, 1973]

IDAHO POWER COMPANY, PETITIONER-APPELLANT

v.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT-APPELLEE

Petition to Review a Decision of the Tax Court of the United States

Before: TRASK and CHOY, Circuit Judges, and McGOVERN,* District Judge

TRASK, *Circuit Judge:*

The taxpayer, Idaho Power Company, appeals from a Tax Court decision denying taxpayer's depreciation deduction on equipment used in the construction of capital improvements. Under the Tax Court decision the taxpayer was ordered to pay deficiencies in income taxes for the taxable years 1962 and 1963 in the amounts of $73,023.47 and $50,342.21, respectively.

The Tax Court ruled against the taxpayer on the single issue—whether the taxpayer is entitled to deduct depreciation on depreciable equipment to the extent such equipment is used in the construction of its

*Honorable Walter T. McGovern, United States District Judge, for the Western District of Washington, sitting by designation.

own capital assets. The Tax Court treated the depreciation as a cost of the construction of the new facilities and ruled such costs must be capitalized as part of the basis of the property constructed under section 263 of the Internal [2] Revenue Code of 1954.[1] We agree with the taxpayer's position that the current depreciation should be treated as a current deduction under section 167 of the Code.[2] The decision of the Tax Court is therefore reversed.

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[1] "§ 263. CAPITAL EXPENDITURES

"(a) General Rule.—No deductions shall be allowed for—

"(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. This paragraph shall not apply to—

"(A) expenditures for the development of mines or deposits deductible under section 616,

"(B) research and experimental expenditures deductible under section 174,

"(C) soil and water conservation expenditures deductible under section 175, or

"(D) expenditures by farmers for fertilizer, etc., deductible under section 180."

[2] "§ 167. DEPRECIATION

"(a) General Rule.—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

"(1) of property used in the trade or business, or

"(2) of property held for the production of income.

"(b) Use of certain methods and rates.—For taxable years ending after December 31, 1953, the term "reasonable allowance" as used in subsection (a) shall include (but shall not be limited to) an allowance computed in accordance with regulations prescribed by the Secretary or his delegate, under any of the following methods:

"(1) the straight line method,

"(2) the declining balance method, using a rate not exceeding twice the rate which would have been used had the annual allowance been computed under the method described in paragraph (1).

The taxpayer is a public utility engaged in the production, transmission and sale of electricity. Since at least 1929, the taxpayer has regularly constructed additional transmission and distribution [3] facilities using its own employees and equipment for a major part of the work. In 1962 it constructed $7,139,940.72 worth of facilities and in 1963, $5,642,342.79 worth. In some years it has used as many as 300 employees in construction and at the time of trial 140 were engaged in such work in question. During the years, the taxpayer has owned cars, trucks, trailers and radio equipment which have been used in part to operate and maintain existing facilities and in part to construct new capital assets.

On its books the taxpayer capitalized the depreciation to the extent the equipment was used in the construction of capital assets in accordance with accounting procedures prescribed by the Federal Power Commission and adopted by the Idaho Public Utilities Commission.[3] On its income tax returns for 1962 and

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"(3) the sum of the years-digits method, and

"(4) any other consistent method productive of an annual allowance which, when added to all allowances for the period commencing with the taxpayer's use of the property and including the taxable year, does not, during the first two-thirds of the useful life of the property, exceed the total of such allowances which would have been used had such allowances been computed under the method described in paragraph (2)."

[3] It should be noted that the taxpayer in *Spring Valley Water Co.*, 5 B.T.A. 660 (1926), charged interest payments on funds borrowed for construction of a dam to its capital account as required by law for public utilities. The taxpayer was allowed a current deduction for such payments, notwithstanding the method of accounting used for its books. The fact that the taxpayer in the case at bar was required to capitalize the depreciation on its books for purposes of the Federal Power Com-

1963, however, the taxpayer deducted all depreciation on its transportation equipment, including depreciation on the equipment to the extent it was used in construction. Such equipment was depreciated over a composite life of ten years. All other costs allocable to the constructed facilities, except pension contributions, social security taxes and motor vehicle taxes, which were also deducted currently, were capitalized by the taxpayer. This included costs of operating and maintaining such equipment. The Commissioner of Internal Revenue disallowed and capitalized the deduction for depreciation on taxpayer's equipment to the extent that such equipment was used in the construction of capital assets and allowed instead a deduction for depreciation of the amounts so capitalized over the useful life of the property so constructed. The construction, consisting principally of transmission and distribution facilities, had useful lives of 30 years or longer. The result of this adjustment was the net disallowance by the Commissioner [4] of depreciation claimed by the taxpayer during the years 1962 and 1963 in the respective amounts of $140,429.75 and $96,811.95.

I. THE DEPRECIATION DEDUCTION

A re-examination of the purpose of the depreciation deduction, its place in the statutory scheme and its history will assist us in solving the problem. It is the basic theory of depreciation that capital assets

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mission and the Idaho Public Utilities Commission is likewise irrelevant as to the proper tax treatment of depreciation deductions. *See Old Colony Ry. Co.* v. *Commissioner*, 284 U.S. 552, 562 (1931); *Mine Hill & Schuylkill Haven R.R. Co.* v. *Smith*, 184 F. 2d 422 (3rd Cir. 1950), *cert. denied*, 340 U.S. 932 (1951).

which are used in the business should not be exhausted without a provision for their replacement. To that end depreciation over the life of the asset provides the means by which the taxpayer can recover its cost. One way of expressing this very practical approach was that of the Supreme Court in *Knoxville* v. *Knoxville Water Co.*, 212 U.S. 1, 13–14 (1909):

> A water plant, with all its additions, begins to depreciate in value from the moment of its use. Before coming to the question of profit at all the company is entitled to earn a sufficient sum annually to provide not only for current repairs but for making good the depreciation and replacing the parts of the property when they come to the end of their life. The company is not bound to see its property gradually waste, without making provision out of earnings for its replacement. It is entitled to see that from earnings the value of the property invested is kept unimpaired, so that at the end of any given term of years the original investment remains as it was at the beginning. It is not only the right of the company to make such a provision, but it is its duty to its bond and stockholders, and, in the case of a public service corporation at least, its plain duty to the public. If a different course were pursued the only method of providing for replacement of property which has ceased to be useful would be the investment of new capital and the issue of new bonds or stocks. This course would lead to a constantly increasing variance between present value and bond and stock capitalization—a tendency which would inevitably lead to disaster either to the stockholders or to the public, or both.

Although that case did not involve an income tax problem, it states the underlying theory of the deduction.

[5] The purpose of the depreciation allowance under the Code is "to permit the taxpayer to recover his capital investment in wasting assets free of income tax." 4 *Mertens, Law of Income Taxation* § 23.04. The Supreme Court has said that the purpose of the depreciation deduction is to create a fund to restore the property, to the extent of the investment of the taxpayer, at the end of its useful life:

> The end and purpose of it all is to approximate and reflect the financial consequences to the taxpayer of the subtle effects of time and use on the value of his capital assets. For this purpose it is sound accounting practice annually to accrue as to each classification of depreciable property an amount which at the time it is retired will with it salvage value replace the original investment therein. [*Detroit Edison Co. v. Commissioner*, 319 U.S. 98, 101 (1943).]

In *Massey Motors, Inc. v United States*, 364 U.S. 92, 96 (1960), the Supreme Court allowed a depreciation deduction on automobiles used by dealers or their employees, explaining:

> Such assets, employed from day to day in business, generally decrease in utility and value as they are used. It was the design of the Congress to permit the taxpayer to recover, tax free, the total cost to him of such capital assets; hence it recognized that this decrease in value—depreciation—was a legitimate tax deduction as business expense. It was the purpose of § 23(l) and the regulations to make a meaningful allocation of this cost to the tax periods benefited by the use of the asset.[4]

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[4] The Treasury Regulations under the 1954 Internal Revenue Code are to the same effect:

"§ 1.167(a)-1. Depreciation in General.

"(a) *Reasonable allowance.* Section 167(a) provides that a reasonable allowance for the exhaustion, wear and tear, and

[6] The issue here does not affect the amount of the depreciation to which the taxpayer is entitled. Whether it is spread over a ten-year life or a thirty-year life, the amount remains the same. It does affect the timing of the recovery of the depreciation and thus might have a vital effect on the ability of a taxpayer to maintain and replenish its equipment inventory without depleting its working capital or burdening its borrowing capacity.

The legislative history of the depreciation deduction clearly supports our decision in favor of the taxpayer. "Prior to the enactment of the Internal Revenue Code of 1954, the statutory provisions for depreciation were singularly brief." 4 *Mertens, supra* at § 23.01. Section 23 (l) of the 1939 Act, contained only a bare statement similar to the general rule in section 167(a) of the 1954 Act,[5] and a two sentence paragraph stating the method of computation as between a life tenant and a remainderman. When Congress adopted the Internal Revenue Code of 1954, however, it gave particular attention to liberalized depreciation allowances. It provided for the use of new methods and rates, in addition to the standard straight line method. These included a declining balance method, a sum of the years-digits method and a fourth

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obsolescence of property used in the trade or business or of property held by the taxpayer for the production of income shall be allowed as a depreciation deduction. The allowance is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property as provided in section 167(g) and section 1.167(g)–1."

[5] *Supra* note 2.

method which was any one consistently applied so long as the total at the end of each year did not exceed the allowances which would have resulted from the use of the declining balance method.*

Further, the report of the Ways and Means Committee on H.R. 8300, which became the Internal Revenue Code of 1954, stated at the beginning of its discussion of this subject:

> "Your committee's bill provides for a liberalization of depreciation with respect to both the estimate of useful life of property and the method of allocating the depreciable cost [7] over the years of service." H.R. No. 1337, 83rd, Cong., 2nd Sess., 1954 U.S. Code Cong. & Adm. News at 4047.

The report emphasized the importance of the liberalized policies of the bill. It pointed out its reliance upon the use of an improved declining balance method of computing depreciation which "concentrates deductions in the early years of service and results in a timing of allowances more in accord with the actual pattern of loss of economic usefulness." *Id.* at 4048. The report continued:

> More liberal depreciation allowances are anticipated to have far-reaching economic effects. The incentives resulting from the changes are well timed to help maintain the present high

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* The Ways and Means Committee noted:

"The depreciation allowances under this method, therefore, [declining-balance] are considerably larger in the early years of the life of a property than those resulting from the straight-line method. The declining-balance method at twice the appropriate straight-line rate will write off approximately 40 percent of the cost of an asset in the first quarter of its service life and two-thirds of the cost in the first half of its life." H.R. No. 1337, 83rd Cong., 2nd Sess., 1954 U.S. Code Cong. & Adm. News at 4047.

level of investment in plant and equipment. The acceleration in the speed of the tax-free recovery of costs is of critical importance in the decision of management to incur risk. The faster tax write-off would increase available working capital and materially aid growing business in the financing of their expansion. For all segments of the American economy, liberalized depreciation policies should assist modernization and expansion of industrial capacity, with resulting economic growth, increased production, and a higher standard of living. [*Id.*]

II. TAXPAYER'S ARGUMENT

The taxpayer argues that deductions specifically allowed and set out under the Internal Revenue Code of 1954 should not be capitalized even though incurred by the taxpayer in constructing facilities for its own use. Such deductions include interest (section 163), taxes (section 164) and depreciation (section 167). These particular deductions, expressly enumerated in the Code, differ from the general deduction for ordinary and necessary business expenses, which is not available whenever the amount expended is determined to be a capital expenditure rather than a current business expense. This interpretation of the Code's overall scheme is in harmony with the Tax Court's decision in *All-Steel Equipment Inc.*, 54 T.C. 1749 (1970), *rev'd on other grounds,* 467 F. 2d 1184 (7th Cir. 1972).

[8] The issue there was whether certain expenditures for taxes, losses and research and experiment were to be included in the cost of inventory (comparable to the capitalization of expenditures for capital assets). Because these three items are expressly listed

in the Code as proper deductions under sections 164, 165 and 174, they are not to be deferred even though they relate to inventory or capital items. The Tax Court explained:

> Secondly, the petitioner contends that the respondent also erred in his determination by requiring the inclusion of certain costs in inventory even though the current deductibility of such costs is expressly authorized by the Code and regulations. The expenditures referred to by the petitioner involve costs incurred for repairs, taxes, losses, and research and experiment. We agree with the petitioner that such expenditures are currently deductible and are excludable from inventory costs.
>
> Deductions for taxes, losses, and research and experiment are expressly authorized in the year the taxes are paid or accrued, the losses are sustained, or the research and experimental expenditures are paid or incurred. Secs. 164, 165, 174. Neither the statutory provisions nor the regulations indicate in any way that such deductions are limited to current expenses as distinguished from capital expenditures for the acquisition of capital assets or inventory. To the contrary, it has been held that deductions expressly granted by statue are not to be deferred even though they relate to inventory or capital items. *Montreal Mining Co.*, 2 T.C. 688 (1943); *Spring Valley Water Co.*, 5 B.T.A. 660 (1926); *Pacific Coast Redwood Co.*, 5 B.T.A. 423 (1926). See also *Joe W. Stout*, 31 T.C. 1199 (1959), affirmed and modified on other issues sub nom. *Rogers v. Commissioner*, 281 F.2d 233 (C.A. 4, 1960). *Cf.* sec. 266; *Rev. Rul.* 141, 1953-2 C.B. 101. Moreover, section 174 expressly states that research and experimental expenditures may be treated 'as expenses which are not chargeable to capital account.' [54 T.C. at 1759.]

Depreciation, under section 167, is likewise expressly listed as a proper deduction and no exception is made should it relate to a capital item.[7]

[9] The precise issue of this case was raised in an early railroad case. *Great Northern Ry. Co.*, 30 B.T.A. 691 (1934). The railroad there, like the taxpayer here, used its equipment for the construction of additions to the taxpayer's property. The court reversed the Commissioner's determination and held that the full amount of depreciation of the equipment, including the period that it was used for construction, should be allowed. The court decided the equipment was used by its owner in a trade or business as the taxpayer maintained and that "it is a part of the regular business of a railroad to construct additional capital facilities for the transaction of its business as a common carrier." 30 B.T.A. at 708. The allowance of the depreciation deduction rather than capitalization of such costs was deemed appropriate because the statutory conditions for the deduction were satisfied.[8]

In further support of its position, taxpayer points out that section 263 providing for capital expenditures states:

> (a) . . . No deduction shall be allowed for—
> (1) Any amount *paid out* for new buildings or for permanent improvements or betterments made to increase the value of any property or estate." [Emphasis supplied]

The use of the term "paid out," argues the taxpayer, was not without significance. There is nothing

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[7] Depreciation was apparently not before the court in *All-Steel Equipment, Inc.*

[8] The revenue laws have uniformly required that a depreciation deduction be allowed for "property used in the trade or business." 4 *Mertens, Law of Federal Income Taxation* § 23.03.

in the Internal Revenue Code which says that for purposes of section 263 depreciation is an amount "paid out" or an "expenditure." On the contrary in construing other sections, the decisions have held that depreciation is not an amount "paid out." In section 170(a)(1), for example, a deduction is allowed for "... any charitable contribution ... payment of which is made within the taxable year." It has been held that an allowance for depreciation is not a payment within the meaning of this section. Thus in *Orr* v. *United States,* 343 F. 2d 553 (5th Cir. 1965), a taxpayer used his automobile and airplane in work for the Methodist Church. The court held that a charitable deduction was not permissible to the extent of the depreciation arising from such activity because such an allowance was not a payment.

> [10] It is entirely possible, as the taxpayer suggests, that Congress and its Committees were not thinking of depreciation when they used the word "payment". The absence of any evidence as to whether Congress focused on this problem provides no basis for extending the meaning of payment to include "depreciation". A depreciation expense is an indispensable element in accounting. But it is not a "payment", not a transfer of money or property. We are bound by plain, prosaic language of the statute. [343 F. 2d at 556.]

In *Clinton H. Mitchell,* 42 T.C. 953 (1964), the Tax Court said:

> Depreciation is a "decrease in value." *Massey Motors, Inc.* v. *United States,* 364 U.S. 92. It is not a payment, or expenditure, or an out-of-pocket expense. Hence, it cannot be considered as a contribution, payment of which is made within the taxable year. 42 T.C. at 973.

As another example, we note that section 213 of the Internal Revenue Code provides for deduction of medical and dental expenses equal to:

> (1) The amount by which the amount of the expenses paid during the taxable year . . . exceeds three percent of the adjusted gross income. . . .

In *Maurice S. Gordon*, 37 T.C. 986 (1962), it was held that depreciation on an automobile used to transport a taxpayer's son to a doctor could not qualify as a medical expense upon the ground that it was not "an amount paid."

> The statute permits the deduction for "expenses paid" and "amounts paid" and respondent correctly interprets the statute as permitting deduction for "medical expenses actually paid." Sec. 1.213–1(a), Income Tax Regs. Depreciation is a "decrease in value." *Massey Motors Inc.* v. *United States*, 364 U.S. 92, 96. Any allowance for depreciation is not an "expense paid" or "amount paid." [37 T.C. at 987.]

It appears to us there is both merit and judicial support for the taxpayer's argument here.

III. THE TAX COURT DECISION

[11] The Tax Court disposed of the taxpayer's arguments by emphasizing that depreciation incurred in the acquisition of capital assets should be treated as part of the cost thereof. In Revenue Ruling 59–380, 1959–2 Cum. Bul. 87, the Internal Revenue Service specifically dealt with the issue in this case:

> Depreciation sustained on construction equipment owned by a taxpayer and used in the erection of capital improvements for its own use is not an allowable deduction, but shall be added to

and made a part of the cost of the capital improvements. So much thereof as is applicable to the cost of depreciable capital improvements is recoverable through deductions for depreciation over the useful life of such capital improvements.

In the instant case the capital improvements constructed constitute property to be used in the trade or business or property held for the production of income. However, the building equipment used in the construction cannot be considered as property used in the regular trade or business of the taxpayer.

In a recent case factually similar to this case, the Court of Claims followed Revenue Ruling 59–380. *Southern Natural Gas Co.* v. *United States,* 412 F. 2d 1222, 1264–69 (Ct. Cl. 1969).[9] The taxpayer contends the court's decision was erroneously based on incorrect assumptions. We agree. First, the Court of Claims could see no reason "for carving out a special exception for depreciation" on the automotive equipment of the company to the extent it was used to construct additional pipelines for its own capital improvements. Neither the Southern Natural Gas Company nor the Idaho Power Company, however, was seeking a special exception. Both based their claims on the express language of the Internal Revenue Code authorizing a depreciation deduction.

Second, the Court of Claims was concerned that a double recovery of cost would result if a depreciation deduction were cur-[12]rently allowed on the equipment—first, when the depreciation was deducted and second when the constructed asset was depreciated

[9] The Court of Claims approved the decision of the Trial Commissioner. Neither the taxpayer nor the United States took exception to the Commissioner's finding on the issue involved here.

or sold. This assumption is patently incorrect. There is no possibility of double recovery because the cost basis of the capital asset would not include the depreciation theretofore deducted.

Third, the court harbored an unfounded fear that the interpretation urged by the appellant if pushed to its logical conclusion would leave the taxpayer without a basis for self-constructed assets. A taxpayer's actual expenditures for labor and materials, however, must be capitalized as part of the basis of the capital improvements under the requirements of section 263 which provides for capitalization of amounts "paid out" for capital assets. Such expenses have to be capitalized even though they are expended for self-constructed assets. Also, as we have noted above, the costs of operating and maintaining the equipment must be capitalized. For these reasons we are not persuaded by *Southern Natural Gas* and we conclude Revenue Ruling 59-380 is an improper and incorrect interpretation of the law.[10]

Furthermore, the strong factual record in this case supports the taxpayer's contention that equipment used to construct its own capital improvements is used in the trade or business of the taxpayer as section 167 requires. The continuity and regularity of taxpayer's construction activities, the number of employees engaged in construction and the amounts ex-

[10] A revenue ruling, as distinguished from a regulation or a Treasury decision, does not have the force and effect of law. It is merely the opinion of a lawyer in an agency. A revenue ruling in conflict with revenue statutes is, therefore, without any force. *See, e.g., Bartels v. Birmingham*, 332 U.S. 126 (1947); *Stubbs, Overbeck & Assoc. Inc. v. United States*, 445 F.2d 1142. (5th Cir. 1971); *Lincoln Savings & Loan Ass'n. v. Commissioner*, 422 F.2d 90 (9th Cir. 1970), *rev'd on other grounds*, 403 U.S. 345 (1971); 1 *Mertens, supra* at § 3.20.

pended on construction all point to the conclusion that construction of facilities is a major aspect of the taxpayer's trade or business. These activities are auxiliary operations incident to the taxpayer's principal trade or business of producing, transmitting, distributing and selling electrical energy within the meaning of section 167.[11] We, there- [13] fore, are constrained to distinguish this case from *Southern Natural Gas* where the court determined the taxpayer's equipment was not used in the taxpayer's trade or business to the extent it was used to construct capital assets.[12]

Other cases cited by the Tax Court concerning oil and gas leases are factually distinguishable from the self-constructed capital asset cases. In *L. W. Brooks, Jr.*, 50 T.C. 927 (1968), and *Producers Chemical Co.*, 50 T.C. 940 (1968), the issues involved the allocation of operating costs between two taxpayers—the operator's working interest in a leasehold and his production payment toward acquisition of the leasehold. These cases are analogous to allocation of costs between a life tenant and a remainderman. They are inapposite here where there is only one taxpayer involved. Likewise, *Ben Perlmutter*, 44 T.C. 382 (1964), aff'd, 373 F. 2d 45 (10th Cir. 1967), cited by the Tax Court, was decided on a question of fact. No legal issue was raised as to the validity of a depreciation

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[11] The undisputed testimony of the Superintendent of Engineering and Construction for the company was that construction was undertaken by the company because it thus obtains a better facility at less cost and because contractors are not always available to perform the work. R.T. at 22.

[12] The Tax Court here stated, "[o]bviously the acquiring of capital improvements whether by purchase or construction is appropriate if not vital to petitioner's continued operation of its business of producing and selling electric energy . . . ." C.T. at 41-42.

deduction for vehicles used in construction. The extent of their use, if any, was questionable and the issue thus was inconsequential. We do not deem it to be in point on the issue before us.

The judgment is reversed.

United States Court of Appeals for the Ninth Circuit

No. 26,368

IDAHO POWER COMPANY, PETITIONER-APPELLANT

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT-APPELLEE

Before: TRASK and CHOY, Circuit Judges, and McGOVERN,* District Judge

Order for Amendment of Opinion

Page 7 of the slip opinion in the above case is hereby amended by adding a new paragraph at the conclusion of the discussion of point I "The Depreciation Deduction", and just before the beginning discussion of point II "The Taxpayer's Argument", to read as follows:

> Obviously the decision of the court below does not permit the purpose of either the statute, the regulations, the legislative history or the cases interpreting them from being achieved. The assets, for which a depreciation deduction is sought here, have a useful life of ten years. No dispute appears to exist as to this point. If the plain language of the statute is to be fol-

* Honorable Walter T. McGovern, United States District Judge, for the Western District of Washington, sitting by designation.

lowed, the taxpayer should by depreciation allowances recover the cost of those assets within that ten-year period. Yet such costs will not be fully recovered for 30 years if the Commissioner's determination requiring transfer of the depreciation to the new asset is applied.

APPENDIX C

[Filed and entered April 10, 1973]

United States Court of Appeals for the Ninth Circuit

No. 26,368

IDAHO POWER COMPANY, PETITIONER-APPELLANT

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT-APPELLEE

Judgment

UPON PETITION to Review a Decision of the Tax Court of the United States.

THIS CAUSE came on to be heard on the Transcript of the Record from The Tax Court of the United States, and was duly submitted.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court, that the Decision of the said Tax Court of the United States in this Cause be, and hereby is reversed.

A TRUE COPY
ATTEST: May 1, 1973
Dennis R. Mathews, Clerk
by M. Turley, Deputy

U.S. GOVERNMENT PRINTING OFFICE: 1973